Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION THIRD QUARTER 2001

FDIC
DALLAS
REGION

DIVISION OF
INSURANCE

ALAN C. BUSH,
REGIONAL MANAGER

ADRIAN R. SANCHEZ,
REGIONAL ECONOMIST

JEFFREY A. AYRES,
SENIOR FINANCIAL
ANALYST

STEPHEN L. KISER,
ECONOMIC ANALYST

A Message to Our Readers

The FDIC community extends its deepest sympathy to the families, friends, and co-workers of the victims of the attacks on September 11, 2001.

The articles in this edition of the *Regional Outlook* were prepared before the tragic events of September 11. We will assess the implications of these events in future issues of the *Regional Outlook*. The public can rest assured that deposit insurance is in full force—money is safe in an FDIC-insured account.

Regional Perspectives

◆ **A slowing economy, potential for reduced government payments, and new farm legislation in 2002 likely will affect the region's agricultural sector.** *See page 3.*

◆ **Despite prolonged periods of low commodity prices, rising expenses, and recurring drought conditions, strong levels of off-farm income and high levels of government payments have helped avert more serious problems for agricultural producers and their lenders. However, a slowing economy could weaken this support for the industry.** *See page 3.*

◆ **In the aggregate, agricultural banks continue to report strong balance sheets and steady profits, despite depressed agricultural conditions. However, the bottom 5 percent of the Dallas Region's agricultural banks reported a negative average return on assets, continuing a downward trend since 1997.** *See page 6.*

◆ **Although it is unclear what direction the new 2002 farm bill will take, most congressional leaders agree that ad hoc disaster payments are not a long-term solution for farm policy.** *See page 8.*

By the Dallas Region Staff

In Focus This Quarter

◆ ***Slowing Economy Reduces Demand for U.S. Office Space*—A slowing economy has contributed to softening in many U.S. office markets during the first half of 2001. The office vacancy rate has recorded the largest six-month increase in the past 20 years. A combination of trends—a substantial drop in demand for office space and an uptick in construction activity in some markets—has led to this slackening.**

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness. It notes the role played by the changing fortunes of high-tech firms in a number of U.S. metro areas and how this situation has contributed to large increases in the volume of space available for sublease. Finally, the article focuses on the local construction and commercial real estate loan exposures of FDIC-insured banks and thrifts that have the task of managing their risks under changing market conditions. *See page 9.*

By Thomas A. Murray

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the Dallas Region's ***Regional Outlook,*** please call Alan Bush at (972) 761-2072 or send an e-mail to *abush@fdic.gov.*

The views expressed in the ***Regional Outlook*** are those of the authors and do not necessarily reflect official positions of the Federal Deposit Insurance Corporation. Some of the information used in the preparation of this publication was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the Federal Deposit Insurance Corporation.

Chairman	Donald E. Powell
Director, Division of Insurance	Arthur J. Murton
Executive Editor	George E. French
Writer/Editor	Kim E. Lowry
Editors	Lynn A. Nejezchleb Maureen E. Sweeney Richard A. Brown Ronald L. Spieker
Publications Manager	Teresa J. Franks

Regional Perspectives

- **Despite prolonged periods of low commodity prices, rising expenses, and recurring drought conditions, strong levels of off-farm income and high levels of government payments have helped avert more serious problems for agricultural producers and their lenders. However, a slowing economy could weaken this support for the industry.**

- **In the aggregate, agricultural banks continue to report strong balance sheets and steady profits, despite depressed agricultural conditions. However, the bottom 5 percent of the Dallas Region's agricultural banks reported a negative average return on assets, continuing a downward trend since 1997.**

- **Although it is unclear what direction the new 2002 farm bill will take, most congressional leaders agree that ad hoc disaster payments are not a long-term solution for farm policy.**

A Slowing Economy, Potential for Reduced Government Payments, and New Farm Legislation in 2002 Likely Will Affect the Region's Agricultural Sector

Prolonged weakness in prices, rising expenses, and weather-related issues have decreased operating profitability for most agricultural producers. However, government payments and strong levels of off-farm income have averted more serious problems for agricultural producers and their lenders. Now, signs of a slowing economy and prospects for a new farm bill could weaken these elements currently providing support for the industry. Twenty-two percent of the Region's banks have invested more than a quarter of their loan portfolio in agricultural production and real estate loans and are defined as agricultural banks.[1] Although these banks have performed well to date, they will likely face challenges in this changing environment.

The agricultural industry is important to the Dallas Region and to those insured financial institutions operating in this part of the country. Specifically, the Region leads the nation in cotton and livestock production and produces a substantial amount of the nation's wheat.[2] Total agricultural production for the Region is $23.3 billion, 79 percent of which is derived from the Region's top three commodities.[3]

[1] Bank Thrift and Call Reports, March 31, 2001.

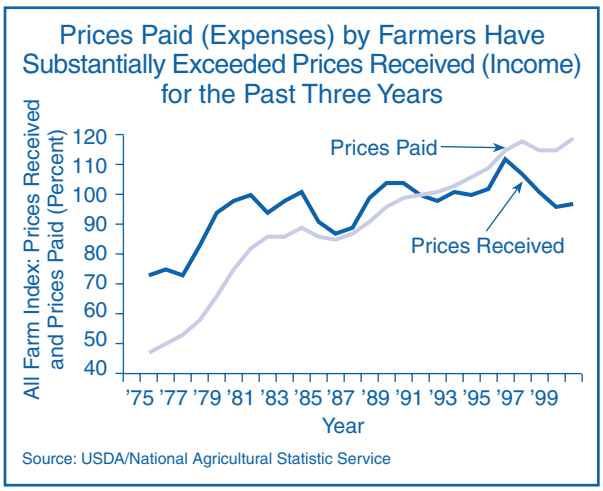
[2] As a percentage of the nation's cash receipts, the Region's share of cotton, cattle, and wheat were 29, 17, and 15 percent, respectively, as of 1999. U.S. Department of Agriculture. *USDA 1999 Cash Receipts*. Washington, DC.

[3] U.S. Department of Agriculture. *USDA 1999 Cash Receipts*. Washington, DC.

Confluence of Issues Continues to Pressure Agriculture

U.S. agriculture has faced depressed commodity prices, recurrent drought conditions in selected areas, and lagging agricultural exports during the past three years (1997 to 2000). According to the ***United States Department of Agriculture All Farm Index***, prices paid by producers have increased while prices received by producers have dropped since 1997 (see Chart 1). Specifically, prices on several commodities in the 1999/2000 marketing year fell to their lowest levels since the 1970s and 1980s. For example, soybean prices declined to 1972/1973 levels; corn and wheat prices fell to 1986/1987 levels; and cotton plummeted to 1974/1975 levels.

CHART 1



A relatively strong dollar and ballooning global supplies of bulk commodities weakened U.S. agricultural exports, exacerbating the slump in commodity prices. Between April 1995 and September 2000, the U.S. agriculture trade-weighted exchange rate (inflation adjusted) appreciated by 25 percent. Over the same period, the U.S. dollar appreciated 42 percent relative to the currencies of U.S. agricultural export competitors.[4] Combined, these developments suppressed U.S. agricultural exports and undermined the agricultural sector growth projections of the U.S. Department of Agriculture (USDA). The Federal Agriculture Improvement and Reform (FAIR) Act of 1996 eliminated government-directed supply controls, which resulted in a new freedom to produce any crop and thus added to near-record surpluses. Global harvest expectations for 2001 will further swell these carryover stocks.

Additionally, recurring drought conditions in many of the Region's production areas have depressed yields for three of the past five years. The National Oceanic and Atmospheric Administration is predicting drought conditions for 2001 in the Pacific Northwest and portions of the Southeast. During a period of low commodity prices, producers facing drought conditions are especially affected because they receive lower prices on declining yields.

Crop Producers Feel Pinch of Low Commodity Prices and Increasing Production Expenses

Producers are also experiencing a sharp increase in production expenses. Total expenses are estimated to have increased by $7.7 billion (4 percent) in 2000, led by a $2.4 billion increase in fuel expenses. Total farm production expenses, including operator dwelling expenses, equaled 89 percent of final agricultural output in both 1999 and 2000 (the highest level since 1983 and the third highest level ever), reflecting very tight operating margins for farmers. Additionally, production expenses are forecast to increase by another $1 billion (1 percent) in 2001, further tightening farmers' operating margins.[5]

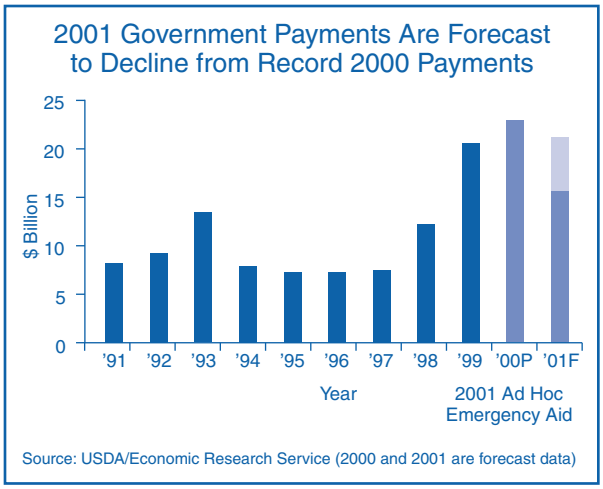
Record Government Payments in 2000 Helped Prevent Large Losses for Farmers

Because of these serious problems, the government has intervened with historic levels of government aid to support farmers' income. Government payments reached a record high of $22.1 billion in 2000 and constituted almost half the estimated 2000 net farm income. This amount included $8.9 billion in emergency relief and $6.4 billion in loan deficiency payments (a direct result of depressed commodity prices). Since the enactment of the 1996 FAIR Act, direct government payments (see Chart 2) have totaled nearly $70 billion, with special emergency relief from Congress comprising 36 percent of direct payments to farmers since 1998.[6] Government payments have been instrumental in preventing large losses to farmers and are helping to insulate insured financial institutions and other agricultural lenders from credit problems.

The Dallas Region Is Benefiting from a Healthy Livestock Sector at a Time When Government Payments Are Budgeted to Decline

Government payments and net farm income for 2001 are forecast to be considerably lower than the previous year. However, Congress recently approved an additional $5.5 billion of emergency aid for the 2001 crop year. Although this allocation indicates a certain level of

CHART 2



[4] Statement by Keith Collins, Chief Economist, USDA, before the U.S. House of Representatives Committee on Agriculture, February 14, 2001.

[5] U.S. Department of Agriculture. October 30, 2000. "Expenses Up Slightly, Led By Fuel, Labor, and Interest." *USDA Agricultural Income and Finance Report*.

[6] Farm Income and Finance. February 22, 2001. "The Importance of Government Payments." *Agricultural Outlook Forum* (Morehart et al.).

concern on behalf of Congress, the $5.5 billion allocation is substantially less than the $9 billion requested by agricultural trade organizations and the $9.7 billion funded the previous year.[7]

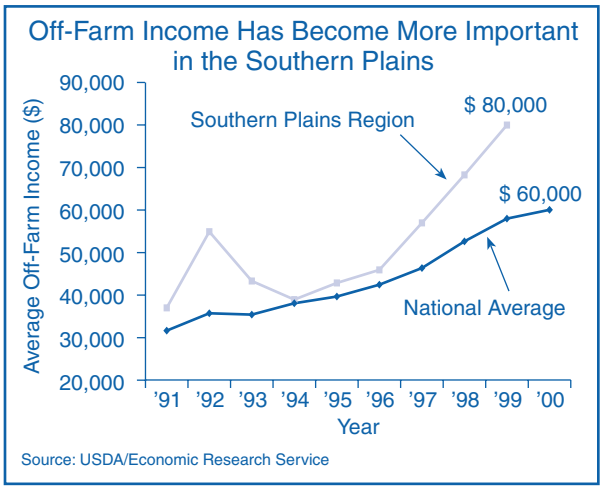
During 1999, 39 percent of the Dallas Region's net farm income was derived from government payments, a figure significantly lower than the 50 percent average nationwide. This difference is attributable to the livestock sector, which does not receive government payments. Specifically, 69 percent of the Region's agricultural cash receipts are derived from livestock products compared with 51 percent for the nation.[8] Livestock prices have performed well during the past two years, and the sector's current strength has somewhat protected the Region from the effects of declining government payments. However, the livestock sector is not entirely insulated from potential problems. For instance, the health and viability of the U.S. livestock industry could be adversely affected if the current outbreak of foot-and-mouth disease in Europe spreads to the United States.

The Importance of Off-Farm Income Has Increased

Another stabilizing effect in the general farm economy is the amount of off-farm income available to cover shortfalls in farming operations. The recent economic expansion, the longest in recorded history, tightened labor markets and created new opportunities for nonfarm employment. Off-farm income for all farm households, including part-time farms, averaged $60,000 at year-end 2000.[9] This represents a 90 percent increase since 1991 (see Chart 3). In the Southern Plains Region,[10] however, off-farm income averaged almost $80,000 per farm household at year-end 1999—an increase of 116 percent since 1991 and 38 percent greater than the U.S. average. This gap is attributable, at least in part, to the large number of smaller part-time cattle operations in the Southern Plains Region.

[7] Jackson, Ben. May 14, 2001. "Farm Group Sees Shortfall in Budget Aid." *American Banker*.
[8] U.S. Department of Agriculture. U.S. and State Income Data 1999. URL: www.ers.usda.gov/data/farmincome/finfidmu.htm.
[9] Statement by Keith Collins, Chief Economist, USDA, before the U.S. House of Representatives Committee on Agriculture, February 14, 2001.
[10] The Southern Plains Region consists of Texas and Oklahoma.

Chart 3



According to the 1997 ***Census of Agriculture***, farms reporting annual sales of $50,000 to $250,000 made up the largest share of commercial farms. This category of farms saw the share of total household income derived from off-farm sources rise to 69 percent, an increase of 11 percentage points from 1991 to 1999. This increased reliance on off-farm income helped mitigate problems that could have resulted from depressed commodity prices and sluggish exports; however, producers and their lenders may be increasingly vulnerable if the general economy experiences a downturn.

The FDIC conducted a survey of agricultural conditions among its Regions. As part of this survey, field office supervisors were asked to estimate the proportion of farmers using off-farm income to *substantially* support farm operations. About 28 percent of field offices surveyed reported that between 50 and 75 percent of farmers use off-farm income. Significantly, 17.9 percent of field offices reported that more than 75 percent of farmers in their areas relied substantially on off-farm income. These responses highlight the importance of off-farm income to the health and viability of agricultural producers.

The effects of an economic downturn on agricultural producers would be twofold. First, a downturn in the general economy could decrease domestic demand for some agricultural commodities or cause consumers to substitute lower-valued products, reducing farm income. Second, a downturn would diminish the overall prospects for off-farm employment and income, increasingly used to supplement total farm household income.

Farmers' Debt Repayment Capacity Points to Increasing Stress in the Agricultural Industry

The historic level of government aid and increasing levels of off-farm income have helped many producers cope, to some degree, with serious financial challenges; however, signs of the underlying stress are beginning to emerge in some of the aggregate debt numbers. In 2000, the USDA estimated[11] that farmers used slightly more than 60 percent of available debt capacity; this is forecast to increase to 65 percent in 2001, the highest level since 1986. Additionally, the USDA estimated that about 50,000 U.S. commercial farms[12] had levels of debt that presented difficulties in repayment or securing additional loans during 1999 and 2000.[13] This volume is forecast to increase by 40 percent to 70,000 during 2001.[14]

Increasing Stress in the Agricultural Industry Has Not Yet Manifested Itself in the Region's Agricultural Bank Portfolios… However, the Worst-Performing Banks Are Continuing to Deteriorate

Collectively, agricultural banks continue to report strong balance sheets and steady profits, despite depressed

Comments from Agricultural Banker Outreach Meeting Indicate Deteriorating Conditions in the Rural Economy

In April of this year, the FDIC hosted two outreach meetings with a number of **Texas** and **Oklahoma** bankers whose financial institutions hold significant agricultural exposure. The groups' consensus described a declining rural economy and mounting pressure on agricultural producers. Key comments are summarized as follows:

- **Credit Quality—**Many of the bankers commented that in the six months prior to the meeting, credit quality had deteriorated. Many producers had experienced eroding equity positions attributable to operating losses caused by depressed commodity price problems and weather-related losses. Declining machinery and equipment values are also affecting producers' equity. Some production areas are beginning to experience stagnant land values and declining cash rents. The prospect for reduced government payments in 2001 could further erode borrower credit quality.
- **Carryover Debt—**Several bankers stated that carryover levels were on the rise and that the first quarter call report should reflect these higher levels. Unless relief comes soon and operations become profitable, bankers will be forced to restructure more existing debts or deny future operating credit to some borrowers.
- **Effects of the 1996 FAIR Act—**The 1996 FAIR Act allows producers to plant alternative crops without forgoing government benefits. Many participants noted that producers did not always switch to the crop best suited for their equipment, location, and production expertise. Although many bankers favored transitioning to a free market approach, most opined that because the global marketplace is not a "level playing field," government intervention is necessary.
- **Importance of Government Payments—**The outcome of the current debate about the 2002 farm bill is very important to agricultural producers and their lenders. Bankers overwhelmingly stated that government payments are necessary for many of their borrowers to repay existing loans and continue to operate. Provisions of the 2002 farm bill will establish the level and mechanism for government assistance to farmers.
- **Rural "Main Street"—**Several of the bankers noted that local businesses serving the agricultural community were more affected by a downturn in the agricultural economy than were the agricultural producers. Anecdotal evidence describes how several businesses started selling nonagricultural products to supplement sales, and local cooperatives are concerned about increasing levels of past-due bills. A few attendees noted that about half of the local business establishments in their area had gone out of business in the past year.

[11] Debt repayment capacity utilization (DRCU) is the amount of debt held by farmers as a percentage of maximum feasible debt. This measure compiled by the USDA is a useful indicator of stress in the agricultural industry.

[12] The USDA estimates that 512,000 commercial farms are currently operating in the United States.

[13] According to USDA Chief Economist Keith Collins, commercial farms with this leverage measure often have difficulty servicing debt. Statement before the U.S. House of Representatives Agriculture Committee, February 14, 2001.

[14] Farm Income and Finance. February 22, 2001. "The Importance of Government Payments." *Agricultural Outlook Forum* (Morehart et al.).

agricultural conditions. This can be attributed in large part to record government payments and rising levels of off-farm income. For example, the Region's 289 agricultural banks[15] reported an average return on assets (ROA) of 1.32 percent as of first quarter 2001, compared with 1.24 percent for all banks in the Region. This follows a decade high ROA of 1.34 percent for year-end 2000.

However, the distribution of ROA for the Region's agricultural banks shows that the difference between the highest and lowest performers has widened since 1996 (see Chart 4). The upper end of the charted performance distribution has noticeably improved since 1997, due in large measure to the adoption of Subchapter S tax status, which became available for financial institutions in March of that year. As of first quarter 2001, 37 percent of all Dallas Region agricultural banks had elected this tax-favored status.

In contrast, the bottom 5 percent of the Dallas Region's agricultural banks reported a negative average ROA (–0.79 percent), continuing the downward trend that began in 1997. To mitigate the effect of different tax structures on agricultural bank profitability, financial institution returns were analyzed on a pretax basis.[16] The difference between the average pretax ROA for the Region's agricultural banks as a group and the worst-performing members[17] of this group is widening. Moreover, the gap between the worst-performing banks and the industry average is increasing at an accelerating pace for the Dallas Region compared with the United States (see Chart 5). Although this divergence was more severe during the farming crisis of the 1980s, it is clear that currently the gap is growing, and the performance of insured institutions in the most poorly performing group warrants further monitoring.

Another sign of this widening gap can be found in the charge-off rate, which, at 2.47 percent for the Region's worst-performing banks, has increased and is significantly higher than the average for the worst-performing agricultural banks nationwide. In fact, the charge-off rate for this low-performing group is almost seven times that of all agricultural banks in the Region. This suggests that these worst-performing agricultural banks are more vulnerable than other insured institutions to any weakening in the overall economy.

CHART 4

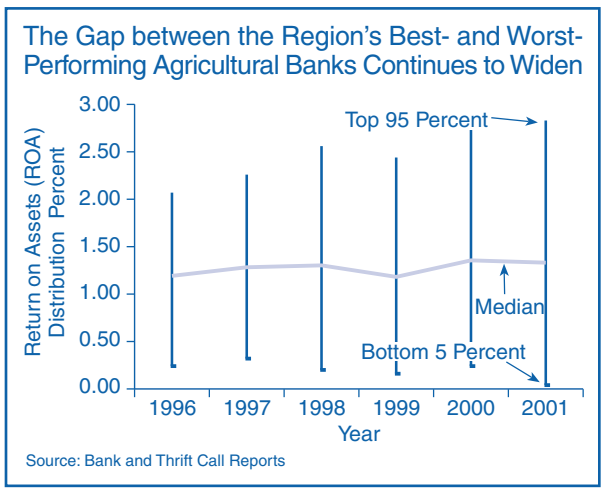
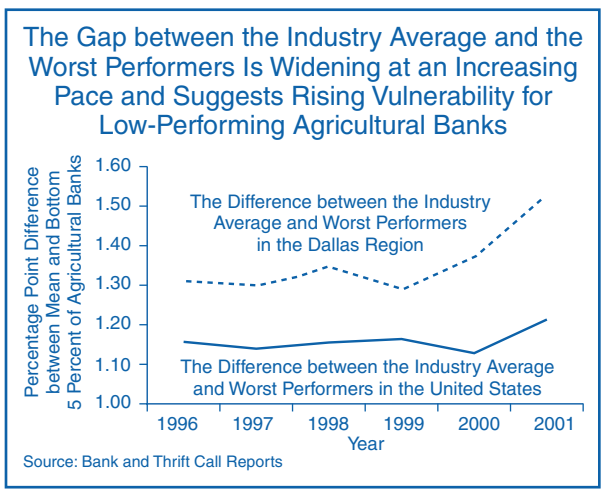


CHART 5



Farm Legislation in the 1980s and 1990s

Recent farm policy history is important to understand as Congress deliberates new initiatives to remedy what many perceive as weaknesses in the 1996 FAIR Act. In 1985, farm policy was steered toward a market-oriented approach for the first time since the Great Depression. This new direction can be attributed to an increased emphasis on reducing the budget deficit with an eye on farm program spending; a recognition that a price support and supply control policy may be disadvantageous to con-

[15] Agricultural banks are defined as banks with agricultural loans greater than 25 percent of total loans.

[16] Pretax analysis was selected to remove the Subchapter S bias evident in the upper range of the ROA distribution.

[17] The worst-performing banks were defined for the purpose of this analysis as banks that had lower pretax ROA scores than 95 percent of all agricultural banks. In other words, the worst performers were in the bottom five percentile of agricultural banks in the Dallas Region. This methodology was chosen to remove outlier bias.

sumers and the environment; and a growing awareness that a relatively small number of producers accounted for the majority of output and had larger household incomes on average than nonfarm households.[18]

Between 1985 and 1990, changes in farm legislation addressed these concerns by reducing government intervention in agriculture. This was accomplished by slightly lowering the amount of assistance available to farmers in various programs. Also, payments were partially decoupled from production.

By 1995, high crop prices and large export projections set the stage for significant change in farm legislation. The 1996 FAIR Act contained a "freedom to farm" provision that separated payments from current production and prices, giving farmers almost total planting flexibility.

The 1996 FAIR Act was drafted at a time when high prices and expanding exports portended a vibrant and growing agricultural industry. However, prices started to decline in 1997 when demand for U.S. commodity exports dropped significantly because of the Asian financial crisis. This problem was exacerbated by successive years of bountiful global agricultural production.

In 1996, the U.S. Secretary of Agriculture set loan rates[19] at the maximum level permitted by Congress for corn, wheat, soybeans, and cotton. Shortly afterward, declining prices contributed to ballooning loan deficiency payments and market loans.[20] This portion of government payments to farmers increased from less than $200 million in 1997 to $3.8 billion in 1998, $8 billion in 1999, and a projected $6 billion to $7 billion in 2000. Since 1998, Congress has allocated an additional $25 billion in emergency aid to help cover the shortfall in agricultural receipts. These payments encouraged the additional planting of 4 to 5 million acres, placing further downward pressure on prices and seemingly thwarting the expected market response—a reduction in supply.

[18] Statement of Keith Collins, Chief Economist, USDA, before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry, January 30, 2001.

[19] The agricultural loan rate is the minimum price below which farmers receive market assistance.

[20] For additional information on USDA's production flexibility contracts, marketing loss assistance payments, and marketing assistance loans see URL: http://www.fsa.usda.gov/pas/publications/facts/proflx98.pdf.

The Importance of the 2002 Farm Bill

The consensus among legislators, academics, and industry participants is that the existing farm legislation is flawed and a remedy is needed. Currently, the U.S. House Agriculture Committee is hearing testimony from various farm organizations. Different scenarios have been proposed, ranging from eliminating all farm programs to restoring price supports and acreage controls. Many members of Congress support keeping a market-oriented farm bill with provisions to support farm income. Although it is unclear at this time what direction the farm bill will take, most congressional leaders agree that ad hoc disaster payments are not a long-term solution. In addition, U.S. Secretary of Agriculture Ann Veneman has emphasized the Bush Administration's position that farmers and ranchers need a safety net that is consistent with the free market and that gives them the opportunity to prosper in an evolving and dynamic global marketplace.[21]

Conclusion

The agricultural industry has faced myriad problems since the enactment of the 1996 FAIR Act. Low prices, declining exports, ballooning surpluses, and weather-related problems have prompted Congress to allocate a tremendous amount of financial aid to stabilize the farm economy. This assistance has helped prevent a crisis in the agricultural industry and ultimately benefited agricultural lenders as well. However, the effects of a slowing economy could weaken current levels of supplementary off-farm income.

Additionally, the 1996 FAIR Act expires in 2002. New farm legislation could change the level and nature of payments to agricultural producers. The combination of lower levels of off-farm income (as a result of slowing economic growth) and declining farm income (due to reduced government payments during a period of agricultural uncertainty) could weaken many agricultural producers' ability to repay existing debt or acquire new loans.

By the Dallas Region Staff

[21] Remarks of Secretary of Agriculture Ann M. Veneman at the Sparks Companies 9th Annual Food and Agriculture Policy Conference, April 17, 2001.

Slowing Economy Reduces Demand for U.S. Office Space

- **Demand for U.S. office space contracted during the first half of this year as the amount of newly vacated space exceeded the amount of newly occupied space for the first time since at least 1981.**

- **The U.S. office vacancy rate jumped 250 basis points in the first half of 2001, from 8.3 percent to 10.8 percent.**

- **With construction levels remaining high and demand still weak, the vacancy rate could rise further by year-end.**

Overview

Commercial real estate (CRE) markets traditionally have been—and remain—highly cyclical. During the 1990s, most U.S. office markets experienced a strong upswing. However, declining office employment growth along with other recent signs point to a possible downturn. As reported by ***Torto Wheaton Research*** (TWR), the U.S. office vacancy rate, which stood at a 19-year low of 8.3 percent at the end of 2000, jumped in only six months to 10.8 percent, the largest six-month increase in the 20 years TWR has tracked these data. Office vacancy increases range from modest levels in some markets to high levels in markets where supply and demand imbalances are more pronounced.

An uptick in construction activity combined with a substantial drop in demand for office space has led to a slackening of office market conditions. In light of the ongoing uncertainty as to the near-term direction of the U.S. economy, these trends make the current situation difficult for office market participants to read.

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness.[1] It notes the role played by the changing fortunes of high-tech firms in a number of metropolitan areas and how this situation has increased the volume of space available for sublease. Finally, the article focuses on the local construction loan exposures of insured banks and thrifts that have the task of managing their risks under changing market conditions.

Vacancy Rates Have Risen Quickly from Cyclical Lows

At year-end 2000, the U.S. office vacancy rate stood at 8.3 percent—a 19-year low. Many individual metro areas posted even lower vacancy rates. For example, at year-end 2000, vacancies were 4.4 percent of available space in Seattle, 1.3 percent in San Jose, and 3.0 percent in Oakland. Beginning with first quarter 2001, as a result of a slowing economy and the fallout from the so-called "tech-wreck," the U.S. vacancy rate rose by 120 basis points to 9.5 percent—the highest absolute quarterly increase since these data were first published in 1981. Another record increase of 130 basis points occurred during the second quarter, bringing the vacancy rate to 10.8 percent. To put these increases in perspective, consider that the national office vacancy rate has increased more than 50 basis points in any given quarter only twice.[2] Nonetheless, the current vacancy rate of 10.8 percent remains low by historical standards, as the average rate for the past 20 years has been 13.9 percent.

Most of the nation's large metro areas saw increases in office vacancies during the first half of 2001. Forty-eight of the 53 major metropolitan areas tracked by TWR recorded a higher vacancy rate in June 2001 than at year-end 2000. Thirty-eight markets experienced increases of at least 100 basis points, and four markets saw vacancy rates jump by more than 600 basis points. As shown in Table 1 (next page), most of the markets experiencing the largest jump in vacancy rates also are home to concentrations of high-tech employment.[3] As

[1] For further discussion of demand and supply trends, see Sally Gordon, "CMBS: Red – Yellow – Green™ Update, Second Quarter 2001 Quarterly Assessment of U.S. Property Markets," *Moody's Investors Service,* July 6, 2001.

[2] TWR notes increases of 60 basis points in the second quarter of 1989 and in the first quarter of 1999.

[3] Seven of the ten markets with the highest first-half 2001 vacancy rate increases are also among the top ten cities having the greatest levels of high-tech employment.

Table 1

In Many Markets, Office Vacancy Rates Reflect Concentrations of High-Tech Employment

Metro Area	Vacancy Rate as of 6/30/01 (%)	Vacancy Rate as of 12/31/00 (%)	Increase in Vacancy Rate (basis points)	High-Tech as % of Total Market Employment
Austin	11.8	5.0	680	10.1
San Jose	8.1	1.3	680	27.4
Oakland	9.3	3.0	630	6.5
San Francisco	10.3	4.1	620	8.3
Seattle	9.4	4.4	500	6.6
Kansas City	15.9	11.0	490	2.7
Boston	8.7	3.9	480	8.2
Phoenix	16.9	12.5	440	4.7
Wilmington, DE	10.4	6.2	420	3.8
Washington, DC	7.8	3.9	390	7.8
Nation	10.8	8.3	250	4.8

Sources: Torto Wheaton Research, Economy.com, Inc.

high-tech markets spurred higher demand for office space in the recent past, these markets are now giving back greater quantities of previously occupied office space. Table 2 (see page 18) lists office vacancy rates and changes along with lending concentrations, construction activity levels, and high-tech employment percentages for 53 major metropolitan areas and for the nation.

Unlike the last cycle, during which office vacancies shot up primarily in overbuilt downtown areas, recent increases are occurring more sharply in suburban than downtown sections of metropolitan areas. As of June 30, 2001, the average downtown office vacancy rate was 8.5 percent, and the average for suburban markets was 12.1 percent. Increases in office availability are dispersed among Class A office properties as well as Class B/C properties, yet vacancy rates do show disparities across many submarkets. For example, the South of Market area in San Francisco reports significantly higher office vacancy rates than the Financial District.[4] Similarly, in the Washington, DC, metropolitan area, the technology-intensive northern Virginia office market has experienced higher office vacancy increases than downtown Washington, DC, or suburban Maryland.

[4] Louis, Arthur M. July 24, 2001. "Empty Offices, Economic Downturn, Overconstruction Leave Commercial Landlords with More Space on their Hands." *San Francisco Chronicle.*

Office Demand Drops

Net absorption, the primary indicator of demand for office space, was negative during first quarter 2001 for the first time since TWR began reporting the series.[5] (Negative absorption occurs when space returned to the market by existing tenants exceeds the space occupied by new tenants.) This negative performance was repeated in the second quarter. The decline in the volume of competitively leased space totaled 30 million square feet during the first half of 2001. (See Chart 1.)

The bulk of negative absorption in the first half of 2001 is due to the return of office space to the market through subleasing.[6] TWR reports that there were 43 million square feet of space "give-backs" through subleasing in the first half of 2001, and after offsetting absorption of 13 million square feet, negative absorption was 30 million square feet.

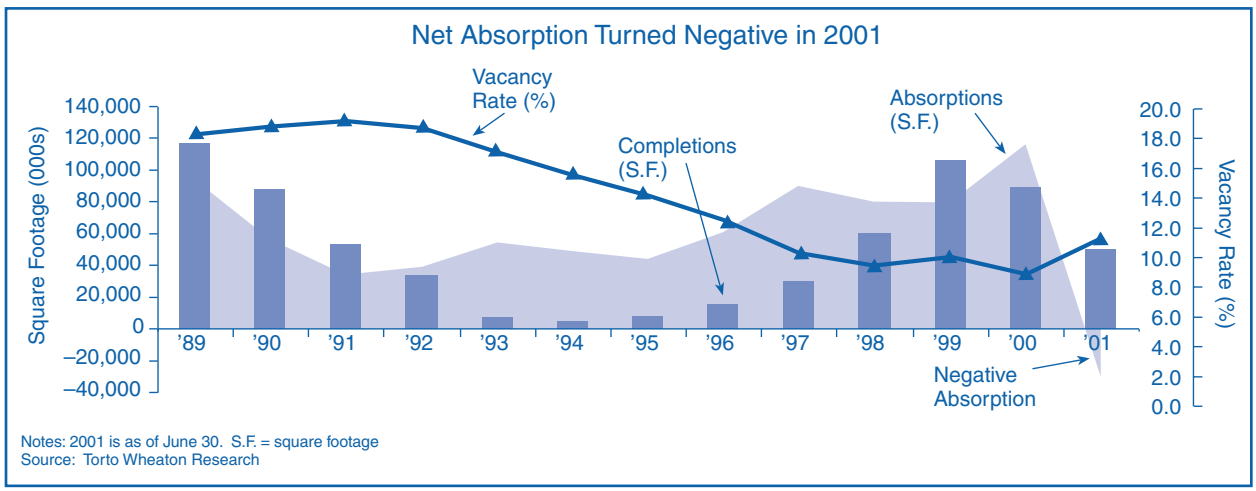
Office employment growth, the source of new office space demand, tends to be driven by the finance and services sectors.[7] Year-over-year job growth in the finance,

[5] Net absorption is the net change in total competitively leased space per period, as measured in square feet.

[6] In some metropolitan areas, over half the total office space available for rent (vacant space) is sublease space.

[7] TWR constructs its office employment index based on trends in the FIRE sector plus selected categories of the services sector. See *TWR Office Outlook,* Spring 2001, Vol. II, p. A.1.

Chart 1



Notes: 2001 is as of June 30. S.F. = square footage
Source: Torto Wheaton Research

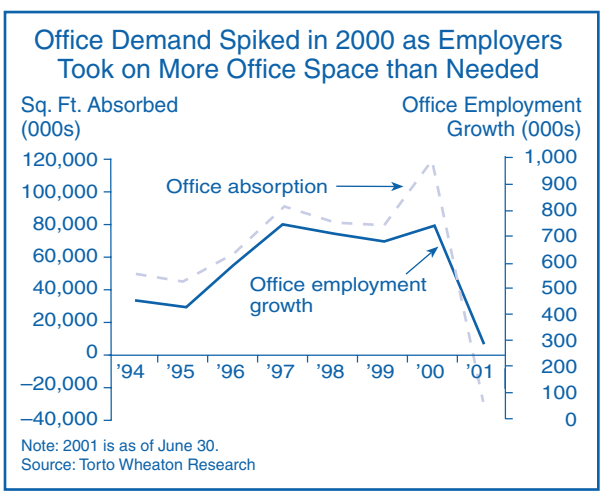
insurance, and real estate (FIRE) and services sectors combined was more than 3 percent in every month from January 1993 through June 2000. Since the middle of 2000, job growth in these sectors has fallen steadily to a year-over-year rate of less than 1.5 percent in June 2001. A spring 2001 survey conducted by ***Salomon Smith Barney*** indicated that tenants estimated their growth in office space demand to be only 0.6 percent over the following 12-month period.[8] Also contributing to reductions in demand are increases in worker layoffs. Announced layoffs during the first seven months of 2001 totaled over 983,000 individuals, more than triple the number of announced layoffs during the same period last year.[9]

The slowdown in the demand for office space contrasts sharply with the situation last year, when absorption rates and office employment growth were robust in most markets, and leases were executed quickly for newly constructed properties. As shown in Chart 2, absorption of office space in 2000 actually outstripped the trend in office employment by a considerable margin. Why? With relatively easy access to initial public offering and venture capital funding, many startup firms anticipated rapid growth and leased office properties accordingly. In fact, venture capital funding facilitated historically higher rates of office space absorption by high-tech and other startups. In active bidding wars, new high-tech firms increased their office space holdings. A phenomenon of *space hoarding* developed in which some high-tech companies leased large quantities of office space in anticipation of future expansion.

More recently, because of a slowing economy, curtailed funding, and failures to achieve sales expectations, many high-tech and dot-com firms have closed or scaled back operations significantly. At the same time, traditional firms have reconsidered plans to expand, adopting a "wait and see" attitude. Consequently, as demand for space declines, large blocks of office space are returning to markets for sublease.

Space available for sublease is similar to landlord-offered space available for rent—space under both categories should count toward a market's available rental space. However, in the case of subleasing, tenants, rather than landlords, offer properties for rent. Tenants may attempt to sublease the property themselves or use a broker; however, in general, only space handled by a broker is included in the tally of a market's available rental space. Consequently, current office vacancy increases could be higher than reported.

Chart 2



Note: 2001 is as of June 30.
Source: Torto Wheaton Research

[8] Boston, Gary, Ross Nussbaum, and Jonathan Litt. May 16, 2001. "Real Estate Demand Survey." *Equity Research: United States, Real Estate Investment Trusts.* Salomon Smith Barney.
[9] Data provided to Haver Analytics by Challenger, Gray & Christmas.

Meanwhile, Construction Continues

An uptick in office construction activity that began in many metro areas during the late 1990s has been a key element contributing to recent increases in office vacancies. According to the ***Bureau of the Census***, U.S. expenditures on office construction totaled $47.5 billion in 2000, continuing a seven-year cycle of expansion. Adjusted for inflation, this amount represents about 78 percent of the peak level of office construction expenditures that occurred in 1985. Recently, the pace of construction has slowed slightly, falling to an annualized rate of $44.3 billion in May 2001.

Reflecting these large dollar outlays on office construction, TWR projected in December 2000 that 111.3 million square feet of new office space (or 3.6 percent of existing stock) would be completed during 2001. This newly completed space will come on the market following a period of rising construction activity from 1998 through 2000, during which the volume of completed office space averaged 84.9 million square feet per year. As shown in Chart 3, however, current office construction activity as a percentage of existing stock falls well below that of the 1980s.

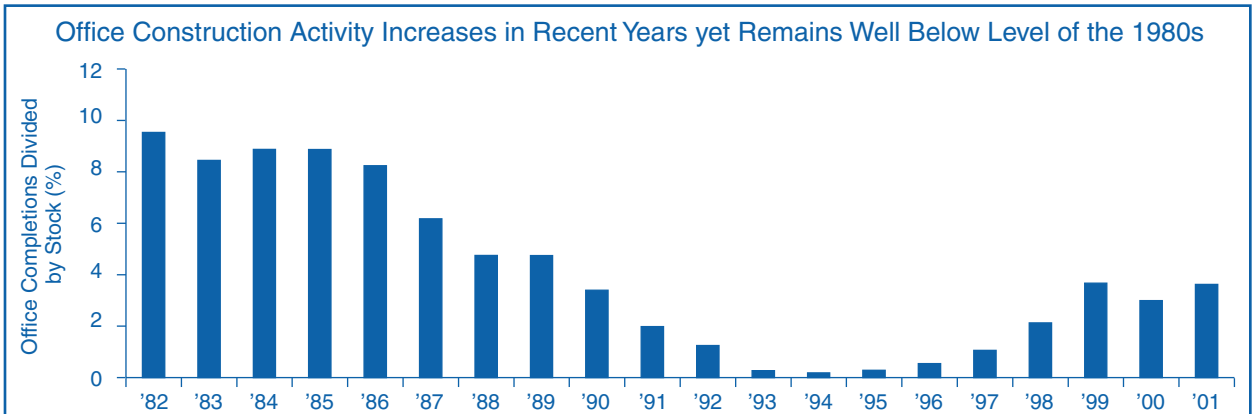
Many metropolitan areas currently experiencing high levels of construction activity also are seeing the largest increases in office vacancies. For example, cities that are positioned toward the upper right quadrant of Chart 4 are characterized by higher vacancy rate increases and more new office space construction. The ten cities with the highest first-half 2001 vacancy rate increases had total square footage of under-construction office space at 6.5 percent of existing stock as of year-end 2000.[10] By comparison, total office space under construction nationally was 4.5 percent of existing stock.[11]

Even as most projects move toward completion, some developers are reconsidering office construction plans. Builders have stopped construction of significant projects midstream in the Austin, Dallas, Seattle, and northern Virginia markets in response to retrenchment by major tenants and competition from subleased space.

Softening Extends to Other Commercial Real Estate

Other major commercial real estate markets are also feeling the effects of a slowing economy and, with the exception of the retail sector, are experiencing increasing vacancy rates.

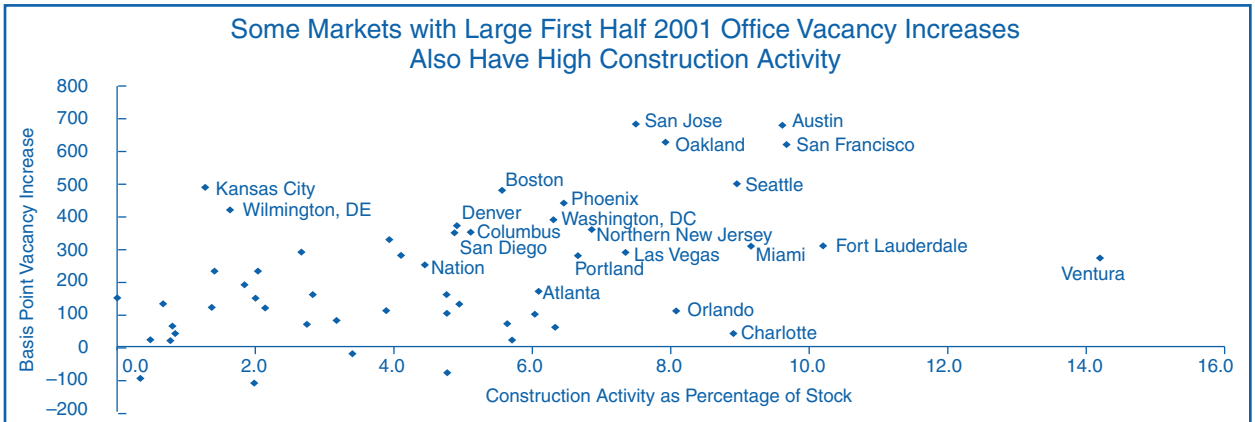
CHART 3



[10] One measure of a metropolitan area's exposure to overbuilding and rising vacancy rates is the degree of construction activity. This measure is found by dividing a metropolitan area's completions square footage or the under-construction square footage by the total stock of office property.

[11] The national 4.5 percent level for office properties *under construction* at December 2000 is higher than the 3.6 percent level for projected *completions* in 2001 because not all properties being built in 2001 will be completed during the year.

CHART 4



Note: Construction activity is measured by a market's under-construction square footage at year-end 2000 divided by total square footage in that market as of year-end 2000.
Source: Torto Wheaton Research, Spring 2001

Industrial vacancy rates had fared well in recent years. As of year-end 2000, the national vacancy rate of 6.7 percent was the lowest since 1984. Now, however, a 150-basis-point increase has occurred, with industrial vacancies increasing to 8.2 percent in the first half of 2001.[12]

As the economy and the nation's high-tech and manufacturing sectors continue to slow, demand for industrial space for research and development and storage and distribution is declining. Industrial property subleasing is on the rise, and negative absorption occurred in the first half of 2001. At the same time, completions of industrial space during 2001 are estimated to exceed 220 million square feet, the highest level since 1988. Landlords are offering concessions, such as lease terms of one year compared with five to ten years, in an attempt to attract new tenants.

Industrial properties are somewhat less exposed to risks from overbuilding than office properties because of shorter construction periods and the ability to respond quickly to any change in demand. An exception is the *telecommunication hotel,*[13] a new entry into this market. This property type is characterized by a longer construction cycle and the fact that it typically has a "single use" design. In recent months, construction of these structures began in many high-tech markets to provide enhanced levels of data service. With declining demand, some telecom hotels stand vacant.

The demand for **hotel** rooms is adversely affected by a slowing economy. Businesses have cut travel budgets and consumers have scaled back leisure plans, contributing to a decline in occupancy levels and revenue per available hotel room in most markets throughout 2001. Currently, upscale and luxury hotels are suffering more than limited service hotels. According to ***Smith Travel Research,*** limited service hotels, particularly budget hotels, represent the only lodging sector with higher occupancy levels through the first four months of 2001 when compared to the same four month period in 2000.

The supply of new hotel properties is lower than in the past, as financing for new hotel construction for the most part has been curtailed in recent years. However, limited service hotels are reported to be overbuilt in a number of markets in the Southeast and Southwest.[14] Annualized expenditures for new construction of all hotel types were $12.1 billion as of May 2001, falling to the lowest level since 1996.[15]

The **multifamily** sector has experienced robust construction and equally strong absorption in recent years as new household formation, the driver for apartment demand, continues to increase. Annualized construction expenditures of $25.5 billion as of May 2001 were at the highest level since 1989.[16] Despite the relative equilibrium between supply and demand for apartments in most markets, vacancy increases and rent declines are occurring in some locations. This decline has been most acute

[12] Torto Wheaton Research.

[13] Telecom hotels are large, high-energy-consuming warehouses that house machinery, servers, routers, and switches that are the physical underpinning of the electronic commerce conducted on the Internet. They are hotels in the sense that they house equipment belonging to many different telecommunication companies. John Holusha, "Home for Machinery of the Internet," *The New York Times,* August 16, 2000.

[14] Kozel, Peter P. June 18, 2001. "U.S. Commercial Property Markets in a Slowing Economy: Implications for CMBS Credit Performance." *Standard and Poor's Structured Finance.*

[15] Data provided to Haver Analytics by U.S. Bureau of the Census.

[16] Ibid.

in the more concentrated high-tech markets, such as San Francisco, where reported average rental rates dropped 8.1 percent between the end of March and the end of May 2001.[17]

Despite a slowing economy, the **retail** sector has performed reasonably well, as consumers maintain relatively high spending levels. Many of the store closings in 2000 and 2001 have been absorbed by new tenants as landlords have acted quickly to avoid letting vacant space linger. Meanwhile, robust construction has continued, with total expenditures in 2000 of $52.6 billion and an annualized level of $52.2 billion as of May 2001. Each of these two years' expenditure levels exceeds all previous years' retail construction amounts since data were first gathered in 1964.[18]

Taking note of the robust level of retail construction activity, a recent ***Moody's*** article finds that the nation's mall retail and "power center"[19] space grew by 3.3 percent in 2000, while population growth expanded by only 1.2 percent. The article raises concerns for potential excess supply of retail space resulting from a construction rate that is almost triple the population growth rate.[20] A negative consequence of the high rate of retail construction is found in a recent ***Standard and Poor's*** study. This article points out that most of the retail mortgages (held in commercial mortgage-backed pools of assets) that defaulted during 2000 did so because of competition from new retail establishments.[21]

Implications for Insured Institutions

Office vacancy rates during the first half of 2001 increased at an unprecedented rate. What does this mean for insured institutions? On the one hand, at mid-2001 vacancy rates remained below their 20-year average. Yet the speed of the increase and the number of metropolitan areas that have experienced softening make this a trend that deserves the close attention of insured institutions, especially those with significant concentrations in commercial real estate and construction lending.

Financial indicators of real estate credit quality in banking remain favorable, with losses and delinquencies trending up modestly from minimal levels. Noncurrent construction and development (C&D) loans as of March 31, 2001, remain at a relatively low .92 percent of all outstanding C&D loans. (Noncurrent C&D loans as a percentage of all C&D loans averaged .93 percent for the past five year-ends.) Similarly, noncurrent CRE loans[22] as of March 31, 2001, were .82 percent of all CRE loans, a level consistent with the average for this ratio of 1.08 percent for the past five year-ends. Charge-off ratios at March 31, 2001, for both C&D and CRE loans were each at .02 percent and remain below the averages of .05 percent for each for the past five year-ends. These favorable numbers are the legacy of a strong economic expansion, whereas current economic events suggest the potential for future deterioration in credit quality.

The outlook for commercial real estate credit quality depends on the depth and duration of the current economic slowdown and on the risk management practices of each institution. In this regard, as signs of increasing risk materialize in conjunction with a declining economy, lenders appear to be managing risks prudently and avoiding speculative lending.[23] Anecdotal information suggests that borrowers are pressed to obtain higher prelease commitment levels in order to gain loan approvals. In addition, lenders are requiring more up-front equity.[24,25]

The importance of risk management practices is magnified by the heightened lending concentrations currently prevailing at some banks. Institutions with elevated concentrations in CRE and C&D lending have been more likely to experience significant problems during times of economic stress (for further details,

[17] Associated Press, News in Brief from the San Francisco Bay Area, June 13, 2001.

[18] Data provided to Haver Analytics by U.S. Bureau of the Census.

[19] According to the Urban Land Institute, a power center is a community shopping center in which at least 75 to 90 percent of the selling space is devoted to multiple off-price anchors and a discount department store or warehouse club. It is the "power" of its anchors that gives the center its name.

[20] Sally Gordon, op. cit.

[21] Kozel, Peter P. April 20, 2001. "Outlook for Property Markets in a Slower-Growing Economy and the Implications for CMBS Credit Performance." *Standard & Poor's Structured Finance.*

[22] CRE loans are nonfarm, nonresidential loans secured by real estate.

[23] Speculative construction lending is defined as a loan not accompanied by a meaningful presale, prelease, or take-out commitment.

[24] "Capital Is Still Plentiful for Right Projects." *Midwest Real Estate News.* July 2001. Vol. 17, No. 7.

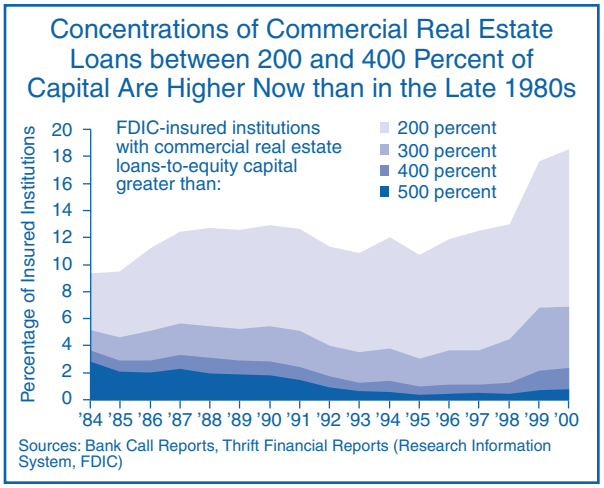
[25] Further information on bank underwriting practices can be found in Federal Deposit Insurance Corporation, Division of Research and Statistics, *Report on Underwriting Practices,* http://www.fdic.gov/bank/analytical/report/index.html.

see *History of the Eighties*[26]). As shown in Chart 5, the percentage of insured institutions with commercial real estate loan concentrations between 200 and 400 percent of capital is higher now than it was in the late 1980s. However, there are relatively fewer institutions at the highest concentration level, in excess of 500 percent of capital. In fact, fewer than 1 percent of insured institutions are at this level. A similar story holds true for construction loans, as the increasing concentrations are in the range of 100 to 300 percent of capital (see Chart 6).

There are a number of issues for construction lenders and commercial real estate lenders to consider going forward. Because uncovered loans (C&D loans made without assurances of a firm take-out commitment) tend to be higher-risk, an important part of managing the risk in construction lending has traditionally been the lender's ability to obtain a take-out commitment.

Sources of take-outs for C&D loans include other insured institutions, pension funds, foreign investors, and life insurance companies, along with public-market real estate investment trusts (REITs) and conventional mortgage-backed securities (CMBSs). Anecdotal reports indicate that shifts in market sentiment in recent months have resulted in lowered investments in REITs and consequently less available capital for REITs to purchase real estate.[27] Insured institutions

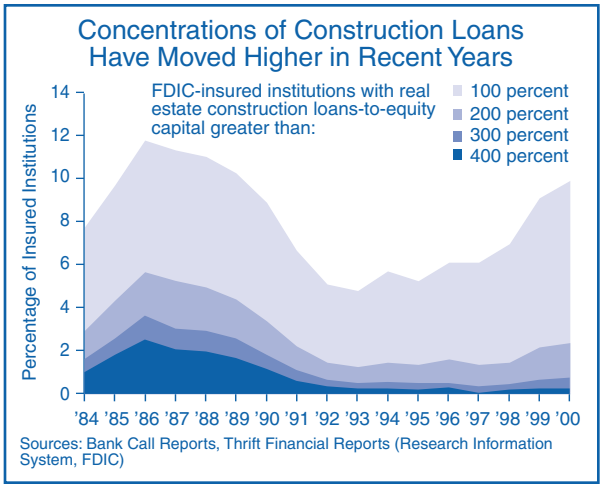
Chart 5



[26] Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future, Vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s,* Chapters 9 and 10. 1997. Washington, DC: FDIC. http://www.fdic.gov/bank/historical/history/index.html.

[27] Smith, Ray A. August 1, 2001. "Property Held by Public Firms Drops." *The Wall Street Journal.*

Chart 6



may face increased challenges to convert construction and development loans into permanent loans should the reported REIT situation become a trend and other sources of permanent capital become less available to purchase C&D loans.

Monitoring economic trends in general, and local real estate trends in particular, becomes even more important during a time of rapid change in market conditions. For example, reliance on appraisals based on outdated or top-of-market assumptions can result in a divergence between expected and realized collateral values or cash flows. Similarly, while preleasing commitments offer significant risk-reduction benefits to lenders, during a time of weakening economic conditions there is at least the possibility that a prospective tenant will be unable to honor a lease obligation, as has been the case with some firms in the high-tech sector in recent months.

Conclusion

Office market trends cannot, of course, be considered in isolation. The recent softening in office markets is a symptom of a slowing economy coupled with a rapid decline in the fortunes of some high-tech firms. Considered in this broader context, the challenge for insured institutions is simply to ensure that risk-management strategies are in place that will succeed under a more challenging economic environment.

Thomas A. Murray
Senior Financial Analyst

Table 2

Office Market and Banking Data on 53 Metropolitan Areas						
Metropolitan Statistical Area	2nd Quarter 2001 Office Vacancy	Basis Point Increase from Year End 2000	Count of Community Banks with C&D Loans	Median C&D as Percentage of Tier 1 Capital at 3/31/2001 (%)	High-Tech as Percentage of Total Market Employment (%)	Office Space Under Const/ Stock at 12/31/2000 (%)
Albuquerque	11.6	-110	9	61.0	6.8	2.0
Atlanta	9.8	170	76	172.2	3.8	6.1
Austin	11.8	680	20	53.4	10.1	9.6
Baltimore	8.9	60	60	22.8	3.6	6.3
Boston	8.7	480	100	24.1	8.2	5.6
Charlotte	9.0	40	20	48.5	1.7	8.9
Chicago	8.9	130	225	33.5	4.5	4.9
Cincinnati	10.1	100	58	32.6	3.1	6.0
Cleveland	13.6	40	16	34.8	3.0	0.8
Columbus, OH	16.9	350	20	22.4	3.1	5.1
Dallas	16.4	110	75	84.5	6.5	3.9
Denver	12.7	370	45	70.4	5.2	4.9
Detroit	12.0	160	28	35.2	3.1	2.8
Ft. Lauderdale	12.8	310	13	19.1	2.7	10.2
Ft. Worth	16.4	130	36	71.8	3.4	0.7
Fresno	14.4	20	5	196.0	0.9	0.8
Hartford	14.0	150	11	25.2	3.5	0.0
Honolulu	12.6	-190	3	11.4	0.9	0.0
Houston	13.6	60	48	65.8	3.1	0.8
Indianapolis	15.8	120	21	29.6	3.3	1.4
Jacksonville	11.7	-20	11	65.2	1.8	3.4
Kansas City	15.9	490	86	70.8	2.7	1.3
Las Vegas	14.5	290	19	117.7	1.5	7.3
Long Island	10.9	190	6	19.1	5.3	1.8
Los Angeles	14.1	150	62	35.4	3.7	2.0
Miami	10.5	310	26	28.1	1.8	9.2
Minneapolis	10.8	20	119	44.0	6.0	5.7
Nashville	12.8	230	20	78.4	1.2	2.0
New York	5.1	230	34	10.5	2.4	1.4
Northern New Jersey	10.9	360	66	15.0	5.6	6.9
Oakland	9.3	630	12	120.0	6.5	7.9
Oklahoma City	20.3	20	44	57.8	2.6	0.5
Orange County	14.7	330	14	34.5	6.4	3.9
Orlando	13.1	110	23	72.1	2.3	8.1
Philadelphia	10.7	80	68	22.1	4.5	3.2
Phoenix	16.9	440	27	114.2	4.7	6.5
Portland, OR	9.9	280	14	118.8	6.6	6.7
Riverside	14.4	-100	18	143.5	1.6	0.3
Sacramento	6.6	70	11	106.9	3.9	5.6
Salt Lake City	15.3	280	14	111.7	4.5	4.1

Table 2 (continued)

Office Market and Banking Data on 53 Metropolitan Areas						
Metropolitan Statistical Area	2nd Quarter 2001 Office Vacancy	Basis Point Increase from Year-End 2000	Count of Community Banks with C&D Loans	Median C&D as Percentage of Tier 1 Capital at 3/31/2001 (%)	High-Tech as Percentage of Total Market Employment (%)	Office Space Under Const/ Stock at 12/31/2000 (%)
San Diego	9.7	350	21	57.5	6.6	4.9
San Francisco	10.3	620	21	69.0	8.3	9.7
San Jose	8.1	680	5	174.5	27.4	7.5
Seattle	9.4	500	30	77.1	6.6	9.0
St. Louis	10.1	-80	80	40.4	2.6	4.8
Stamford	11.2	290	10	43.5	5.6	2.6
Tampa	14.8	70	33	40.0	4.2	2.7
Tucson	8.8	100	3	178.4	4.4	4.8
Ventura	14.2	270	8	49.7	5.4	14.2
Washington, DC	7.8	390	61	51.1	7.8	6.3
Wilmington, DE	10.4	420	12	28.4	3.8	1.6
W. Palm Beach	12.2	160	18	37.2	2.3	4.8
Westchester	12.5	120	4	19.5	12.3	2.1
Nation	10.8	250	(1) 3,801	(1) 40.1	(2) 4.8	(2) 4.5

Notes: Only community banks with construction loans are included in this table. Community banks are institutions with assets less than $1 billion. Noncommunity banks are excluded because their lending activities are likely to span a larger area than the MSA in which they are headquartered.
Sources: Torto Wheaton Research; Bank and Thrift Call Reports, FDIC Research Information System data; Economy.com, Inc.
1. Only community banks with construction loans and located within a MSA are included in these figures.
2. Percentages shown are the averages for the 53 metropolitan areas.

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name _____

Contact Person _____

Telephone _____

Street Address _____

City, State, Zip Code _____

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, DC 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta _____	Dallas _____	New York _____	National _____
Boston _____	Kansas City _____	San Francisco _____	All _____
Chicago _____	Memphis _____		

Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE
MAIL
Postage &
Fees Paid
FDIC
Permit No. G-36